SANDRIDGE ENERGY INC
Form 10-Q
May 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

R QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2014

OR

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 001-33784

SANDRIDGE ENERGY, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	20-8084793 (I.R.S. Employer Identification No.)
123 Robert S. Kerr Avenue Oklahoma City, Oklahoma	73102
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code:
(405) 429-5500

Former name, former address and former fiscal year, if changed since last report: Not applicable

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes R No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R No £

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	R		Accelerated filer	£
Non-accelerated filer	£	(Do not check if a smaller reporting company)	Smaller reporting company	£

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).   Yes £   No R

The number of shares outstanding of the registrant’s common stock, par value $0.001 per share, as of the close of business on April 30, 2014, was 494,367,908.

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References in this report to the “Company” and “SandRidge” mean SandRidge Energy, Inc., including its consolidated subsidiaries and variable interest entities of which it is the primary beneficiary.

DISCLOSURES REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q (“Quarterly Report”) of the Company includes “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These statements express a belief, expectation or intention and generally are accompanied by words that convey projected future events or outcomes. These forward-looking statements may include projections and estimates concerning the Company’s capital expenditures, liquidity, capital resources and debt profile, the timing and success of specific projects, outcomes and effects of litigation, claims and disputes, elements of the Company’s business strategy, compliance with governmental regulation of the oil and natural gas industry, including environmental regulations, acquisitions and divestitures and the effects thereof on the Company’s financial condition and other statements concerning the Company’s operations and financial performance and condition. Forward-looking statements are generally accompanied by words such as “estimate,” “assume,” “target,” “project,” “predict,” “believe,” “expect,” “anticipate,” “potential,” “could,” “may,” “foresee,” “plan,” “goa other words that convey the uncertainty of future events or outcomes. The Company has based these forward-looking statements on its current expectations and assumptions about future events. These statements are based on certain assumptions and analyses made by the Company in light of its experience and perception of historical trends, current conditions and expected future developments as well as other factors the Company believes are appropriate under the circumstances. The actual results or developments anticipated may not be realized or, even if substantially realized, may not have the expected consequences to or effects on the Company’s business or results. Such statements are not guarantees of future performance and actual results or developments may differ materially from those projected in such forward-looking statements. These forward-looking statements speak only as of the date hereof. The Company disclaims any obligation to update or revise these forward-looking statements unless required by law, and it cautions readers not to rely on them unduly. While the Company’s management considers these expectations and assumptions to be reasonable, they are inherently subject to significant business, economic, competitive, regulatory and other risks, contingencies and uncertainties relating to, among other matters, the risks and uncertainties discussed in “Risk Factors” in Item 1A of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2013 (the “2013 Form 10-K”).

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PART I. Financial Information

ITEM 1. Financial Statements
SANDRIDGE ENERGY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	March 31, 2014 (Unaudited)	December 31, 2013
ASSETS		
Current assets		
Cash and cash equivalents	$1,179,644	$814,663
Accounts receivable, net	293,765	349,218
Derivative contracts	9,002	12,779
Costs in excess of billings and contract loss	4,144	4,079
Prepaid expenses	13,567	39,253
Other current assets	25,823	21,831
Total current assets	1,525,945	1,241,823
Oil and natural gas properties, using full cost method of accounting		
Proved	10,443,534	10,972,816
Unproved	292,459	531,606
Less: accumulated depreciation, depletion and impairment	(6,043,109)	(5,762,969)
	4,692,884	5,741,453
Other property, plant and equipment, net	559,342	566,222
Derivative contracts	18,048	14,126
Other assets	82,038	121,171
Total assets	$6,878,257	$7,684,795

The accompanying notes are an integral part of these condensed consolidated financial statements.

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SANDRIDGE ENERGY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS - Continued
(In thousands, except per share data)

	March 31, 2014 (Unaudited)	December 31, 2013
LIABILITIES AND EQUITY		
Current liabilities		
Accounts payable and accrued expenses	$581,764	$812,488
Derivative contracts	14,175	34,267
Asset retirement obligations	—	87,063
Other current liabilities	16,467	—
Total current liabilities	612,406	933,818
Long-term debt	3,195,036	3,194,907
Derivative contracts	—	20,564
Asset retirement obligations	53,103	337,054
Other long-term obligations	20,173	22,825
Total liabilities	3,880,718	4,509,168
Commitments and contingencies (Note 10)		
Equity		
SandRidge Energy, Inc. stockholders' equity		
Preferred stock, $0.001 par value, 50,000 shares authorized		
8.5% Convertible perpetual preferred stock; 2,650 shares issued and outstanding at March 31, 2014 and December 31, 2013; aggregate liquidation preference of $265,000	3	3
6.0% Convertible perpetual preferred stock; 2,000 shares issued and outstanding at March 31, 2014 and December 31, 2013; aggregate liquidation preference of $200,000	2	2
7.0% Convertible perpetual preferred stock; 3,000 shares issued and outstanding at March 31, 2014 and December 31, 2013; aggregate liquidation preference of $300,000	3	3
Common stock, $0.001 par value, 800,000 shares authorized; 495,719 issued and 494,651 outstanding at March 31, 2014 and 491,609 issued and 490,290 outstanding at December 31, 2013	485	483
Additional paid-in capital	5,302,051	5,298,301
Additional paid-in capital—stockholder receivable	(3,750)	(3,750)
Treasury stock, at cost	(6,898)	(8,770)
Accumulated deficit	(3,602,358)	(3,460,462)
Total SandRidge Energy, Inc. stockholders' equity	1,689,538	1,825,810
Noncontrolling interest	1,308,001	1,349,817
Total equity	2,997,539	3,175,627
Total liabilities and equity	$6,878,257	$7,684,795

The accompanying notes are an integral part of these condensed consolidated financial statements.

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SANDRIDGE ENERGY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Three Months Ended March 31,	
	2014	2013
	(Unaudited)	
Revenues		
Oil, natural gas and NGL	$405,316	$478,017
Drilling and services	17,080	17,370
Midstream and marketing	17,910	13,032
Other	2,750	3,271
Total revenues	443,056	511,690
Expenses		
Production	98,535	132,501
Production taxes	7,807	9,439
Cost of sales	12,481	16,317
Midstream and marketing	16,000	11,803
Depreciation and depletion—oil and natural gas	115,185	157,526
Depreciation and amortization—other	15,522	15,336
Accretion of asset retirement obligations	5,746	9,779
Impairment	164,779	—
General and administrative	38,538	79,444
Loss on derivative contracts	42,491	40,897
(Gain) loss on sale of assets	(19)	398,174
Total expenses	517,065	871,216
Loss from operations	(74,009)	(359,526)
Other income (expense)		
Interest expense	(62,043)	(85,910)
Loss on extinguishment of debt	—	(82,005)
Other income, net	2,094	611
Total other expense	(59,949)	(167,304)
Loss before income taxes	(133,958)	(526,830)
Income tax expense	127	4,429
Net loss	(134,085)	(531,259)
Less: net loss attributable to noncontrolling interest	(6,070)	(51,919)
Net loss attributable to SandRidge Energy, Inc.	(128,015)	(479,340)
Preferred stock dividends	13,881	13,881
Loss applicable to SandRidge Energy, Inc. common stockholders	$(141,896)	$(493,221)
Loss per share		
Basic	$(0.29)	$(1.03)
Diluted	$(0.29)	$(1.03)
Weighted average number of common shares outstanding		
Basic	484,798	477,826
Diluted	484,798	477,826

The accompanying notes are an integral part of these condensed consolidated financial statements.

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SANDRIDGE ENERGY, INC.
CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(In thousands)

	SandRidge Energy, Inc. Stockholders								
	Convertible Perpetual Preferred Stock		Common Stock		Additional Paid-In Capital	Treasury Stock	Accumulated Deficit	Non-controlling Interest	Total
	Shares	Amount	Shares	Amount					
	(Unaudited)								
Three Months Ended March 31, 2014									
Balance at December 31, 2013	7,650	$8	490,290	$483	$5,294,551	$(8,770)	$(3,460,462)	$ 1,349,817	$3,175,627
Acquisition of ownership interest	—	—	—	—	(2,074)	—	—	(656)	(2,730)
Sale of royalty trust units	—	—	—	—	4,091	—	—	18,028	22,119
Distributions to noncontrolling interest owners	—	—	—	—	—	—	—	(53,118)	(53,118)
Purchase of treasury stock	—	—	—	—	—	(3,677)	—	—	(3,677)
Retirement of treasury stock	—	—	—	—	(3,677)	3,677	—	—	—
Stock distributions, net of purchases - retirement plans	—	—	251	—	(2,031)	1,872	—	—	(159)
Stock-based compensation	—	—	—	—	7,441	—	—	—	7,441
Stock-based compensation excess tax benefit	—	—	—	—	2	—	—	—	2
Issuance of restricted stock awards, net of cancellations	—	—	4,110	2	(2)	—	—	—	—
Net loss	—	—	—	—	—	—	(128,015)	(6,070)	(134,085)
Convertible perpetual preferred stock dividends	—	—	—	—	—	—	(13,881)	—	(13,881)
Balance at March 31, 2014	7,650	$8	494,651	$485	$5,298,301	$(6,898)	$(3,602,358)	$ 1,308,001	$2,997,539

The accompanying notes are an integral part of these condensed consolidated financial statements.

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SANDRIDGE ENERGY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Three Months Ended March 31, 2014	2013
	(Unaudited)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(134,085)	$(531,259)
Adjustments to reconcile net loss to net cash provided by operating activities		
Depreciation, depletion and amortization	130,707	172,862
Accretion of asset retirement obligations	5,746	9,779
Impairment	164,779	—
Debt issuance costs amortization	2,361	3,008
Amortization of discount, net of premium, on long-term debt	129	672
Loss on extinguishment of debt	—	82,005
Deferred income tax provision	—	4,359
Loss on derivative contracts	42,491	40,897
Cash paid on settlement of derivative contracts	(39,164)	(21,684)
(Gain) loss on sale of assets	(19)	398,174
Stock-based compensation	6,786	19,850
Other	188	(285)
Changes in operating assets and liabilities	(89,468)	(56,921)
Net cash provided by operating activities	90,451	121,457
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures for property, plant and equipment	(331,016)	(421,876)
Acquisition of assets	(2,352)	(5,048)
Proceeds from sale of assets	707,366	2,559,374
Net cash provided by investing activities	373,998	2,132,450
CASH FLOWS FROM FINANCING ACTIVITIES		
Repayments of borrowings	—	(1,115,500)
Premium on debt redemption	—	(61,997)
Debt issuance costs	—	(91)
Proceeds from sale of royalty trust units	22,119	—
Noncontrolling interest distributions	(53,118)	(51,256)
Acquisition of ownership interest	(2,730)	—
Stock-based compensation excess tax benefit	2	—
Purchase of treasury stock	(4,350)	(12,041)
Dividends paid — preferred	(17,263)	(17,263)
Cash (paid) received on settlement of financing derivative contracts	(44,128)	3,208
Net cash used in financing activities	(99,468)	(1,254,940)
NET INCREASE IN CASH AND CASH EQUIVALENTS	364,981	998,967
CASH AND CASH EQUIVALENTS, beginning of year	814,663	309,766
CASH AND CASH EQUIVALENTS, end of period	$1,179,644	$1,308,733
Supplemental Disclosure of Cash Flow Information		
Cash paid for interest, net of amounts capitalized	$(92,896)	$(127,181)
Cash received for income taxes	$—	$476
Supplemental Disclosure of Noncash Investing and Financing Activities		
Deposit on pending sale	$—	$(255,000)
Change in accrued capital expenditures	$55,242	$33,164

Asset retirement costs capitalized	$818	$1,102

The accompanying notes are an integral part of these condensed consolidated financial statements.

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SANDRIDGE ENERGY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

Nature of Business. SandRidge Energy, Inc. is an oil and natural gas company with a principal focus on exploration and production activities in the Mid-Continent region of the United States. The Company owns and operates additional interests in west Texas. The Company also operates businesses and infrastructure systems that are complementary to its primary exploration and production activities, including gas gathering and processing facilities, marketing operations, a saltwater disposal system, an electrical transmission system and a drilling rig and related oil field services business.

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and its wholly owned or majority owned subsidiaries and variable interest entities (“VIEs”) for which the Company is the primary beneficiary. Noncontrolling interest represents third-party ownership interests in the Company’s subsidiaries and consolidated VIEs and is included as a component of equity in the consolidated balance sheets and consolidated statement of changes in equity. All significant intercompany accounts and transactions have been eliminated in consolidation.

Variable Interest Entities. An entity is referred to as a VIE if it possesses one of the following criteria: (i) it is thinly capitalized, (ii) the residual equity holders do not control the entity, (iii) the equity holders are shielded from the economic losses, (iv) the equity holders do not participate fully in the entity’s residual economics, or (v) the entity was established with non-substantive voting interests. The Company consolidates a VIE when it has determined it is the primary beneficiary, which requires significant judgment. The primary beneficiary of a VIE is that variable interest holder possessing a controlling financial interest through (i) its power to direct the activities of the VIE that most significantly impact the VIE’s economic performance and (ii) its obligation to absorb losses or its right to receive benefits from the VIE that could potentially be significant to the VIE. In order to determine whether the Company owns a variable interest in a VIE and the significance of the variable interest, the Company performs a qualitative analysis of the entity’s design, organizational structure, primary decision makers and related financial agreements. In addition to the VIEs that the Company consolidates, the Company also holds a variable interest in another VIE that is not consolidated as it was determined that the Company is not the primary beneficiary. The Company monitors both consolidated and unconsolidated VIEs to determine if any events have occurred that could cause the primary beneficiary to change. See Note 3 for discussion of the Company’s significant associated VIEs.
Interim Financial Statements. The accompanying condensed consolidated financial statements as of December 31, 2013 have been derived from the audited financial statements contained in the Company’s 2013 Form 10-K. The unaudited interim condensed consolidated financial statements have been prepared by the Company in accordance with the accounting policies stated in the audited consolidated financial statements contained in the 2013 Form 10-K. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) have been condensed or omitted, although the Company believes that the disclosures contained herein are adequate to make the information presented not misleading. In the opinion of management, all adjustments, which consist only of normal recurring adjustments, necessary to state fairly the information in the Company’s accompanying unaudited condensed consolidated financial statements have been included. These unaudited condensed consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the 2013 Form 10-K.

Significant Accounting Policies. For a description of the Company’s significant accounting policies, see Note 1 of the consolidated financial statements included in the 2013 Form 10-K.

Reclassifications. Certain reclassifications have been made to the prior period financial statements to conform to the current period presentation. These reclassifications have no effect on the Company’s previously reported results of operations.

Use of Estimates. The preparation of the accompanying unaudited condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period.

The more significant areas requiring the use of assumptions, judgments and estimates include: oil, natural gas and natural gas liquids (“NGL”) reserves; cash flow estimates used in the valuation of guarantees; impairment tests of long-lived assets; depreciation, depletion and amortization; asset retirement obligations; assignments of fair value and allocations of purchase price in connection with business combinations; determinations of significant alterations to the full cost pool and related estimates of fair value used to allocate the full cost pool net book value to divested properties, as necessary; income taxes; valuation of derivative instruments; contingencies; and accrued revenue and related receivables. Although management believes these estimates are reasonable, actual results could differ significantly.

2. Divestitures

Sale of Permian Properties

On February 26, 2013, the Company sold all of its oil and natural gas properties in the Permian Basin in west Texas, excluding the assets attributable to the SandRidge Permian Trust's (the "Permian Trust") area of mutual interest, (the "Permian Properties") for $2.6 billion. This transaction resulted in a significant alteration of the relationship between the Company's capitalized costs and proved reserves and, accordingly, the Company recorded a $399.1 million loss on the sale for the three-month period ended March 31, 2013. The loss is included in (gain) loss on sale of assets in the accompanying unaudited condensed consolidated statement of operations for the three-month period ended March 31, 2013. The loss was calculated based on a comparison of proceeds received and the asset retirement obligations attributable to the Permian Properties that were assumed by the buyer to the sum of (i) an allocation of the historical net book value of the Company's proved oil and natural gas properties attributable to the Permian Properties, (ii) the historical cost of unproved acreage sold and (iii) costs incurred by the Company to sell these properties. The allocated net book value attributable to the Permian Properties was calculated based on the relative fair value of the Permian Properties and the remaining proved oil and natural gas properties retained by the Company as of the date of sale. A portion of the loss, totaling $71.7 million, was allocated to noncontrolling interests and is reflected in net income attributable to noncontrolling interest in the accompanying unaudited condensed consolidated statement of operations for the three-month period ended March 31, 2013.

The following table presents revenues and direct operating expenses of the Permian Properties included in the accompanying unaudited condensed consolidated statement of operations for the three-month period ended March 31, 2013 (in thousands):

	Three Months Ended March 31, 2013(1)
Revenues	$68,027
Direct operating expenses	$17,453

(1) Includes revenues and direct operating expenses through February 26, 2013, the date of sale.

Sale of Gulf of Mexico and Gulf Coast Properties

On February 25, 2014, the Company sold subsidiaries that owned the Company's Gulf of Mexico and Gulf Coast oil and natural gas properties (the "Gulf Properties") for approximately $705.0 million, net of working capital adjustments and subject to post-closing adjustments, and the buyer's assumption of approximately $366.0 million of related asset retirement obligations to Fieldwood Energy LLC ("Fieldwood"). This transaction did not result in a significant alteration of the relationship between the Company's capitalized costs and proved reserves and, accordingly, the Company recorded the proceeds as a reduction of its full cost pool with no gain or loss on the sale. See Note 14 for discussion of Fieldwood's related party affiliation with the Company.

Under the equity purchase agreement, the Company agreed to guarantee on behalf of Fieldwood certain plugging and abandonment obligations associated with the Gulf Properties for a period of up to one year from the date of closing. The Company recorded a liability equal to the fair value of these guarantees, or $9.4 million, at the time the transaction closed. As of March 31, 2014, the fair value of the guarantees was approximately $9.5 million. See Note 4 for additional discussion of the determination of the guarantees' fair value. The guarantees do not include a limit on the potential future payments for which the Company could be obligated; however, Fieldwood has agreed to indemnify the Company for any costs it may incur as a result of the guarantees and to use its best efforts to pay any amounts sought from the Company by the Bureau of Ocean Energy Management that may arise prior to the expiration of the guarantees. Additionally, Fieldwood will maintain, for a period of up to one year from the closing date, restricted deposits totaling approximately $28.0 million held in escrow for plugging and abandonment obligations associated with the Gulf Properties. Upon expiration of the guarantees, the Company will receive payment for half of such restricted deposits, or approximately $14.0 million, from Fieldwood. Accordingly, the Company recorded a receivable for this payment in conjunction with the closing of the sale, which is included in other current assets in the accompanying unaudited condensed consolidated balance sheet at March 31, 2014.

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The following table presents revenues and expenses, including direct operating expenses, depletion, accretion of asset retirement obligations and general and administrative expenses, for the Gulf Properties included in the accompanying unaudited condensed consolidated statements of operations for the three-month periods ended March 31, 2014 and 2013 (in thousands):

	Three Months Ended March 31,	
	2014(1)	2013
Revenues	$90,920	$175,055
Expenses	$63,674	$129,169

(1) Includes revenues and expenses through February 25, 2014, the date of the sale.

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SANDRIDGE ENERGY, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
(Unaudited)

3. Variable Interest Entities

The Company’s significant associated VIEs, including those for which the Company has determined it is the primary beneficiary and those for which it has determined it is not, are described below.

Royalty Trusts. SandRidge owns beneficial interests in three Delaware statutory trusts. SandRidge Mississippian Trust I (the “Mississippian Trust I”), the Permian Trust and SandRidge Mississippian Trust II (the “Mississippian Trust II”) (each individually, a “Royalty Trust” and collectively, the “Royalty Trusts”) completed initial public offerings of their common units in April 2011, August 2011 and April 2012, respectively. Concurrent with the closing of each offering, the Company conveyed certain royalty interests to each Royalty Trust in exchange for the net proceeds of the offering and units representing beneficial interests in the Royalty Trust. Royalty interests conveyed to the Royalty Trusts are in certain existing wells and wells to be drilled on oil and natural gas properties leased by the Company in defined areas of mutual interest. The following table summarizes information about each Royalty Trust upon completion of its initial public offering:

	Mississippian Trust I	Permian Trust	Mississippian Trust II
Net proceeds of offering (in thousands)	$336,893	$580,635	$587,087
Total outstanding common units	21,000,000	39,375,000	37,293,750
Total outstanding subordinated units	7,000,000	13,125,000	12,431,250
Beneficial interest owned by Company(1)	38.4 %	34.3 %	39.9 %
Liquidation date(2)	12/31/2030	3/31/2031	12/31/2031

(1) Subsequent to the initial public offerings, the Company sold common units of the Royalty Trusts it owned in transactions exempt from registration under Rule 144 under the Securities Act. These transactions decreased the Company’s beneficial interests in the Royalty Trusts. See further discussion of the unit sales below.

(2) At the time each Royalty Trust terminates, 50% of the royalty interests conveyed to the Royalty Trust will automatically revert to the Company, and the remaining 50% will be sold with the proceeds distributed to the Royalty Trust unitholders.

The Royalty Trusts make quarterly cash distributions to unitholders based on calculated distributable income. In order to provide support for cash distributions on the common units, the Company agreed to subordinate a portion of the units it owns in each Royalty Trust (the “subordinated units”), which constitute 25% of the total outstanding units of each Royalty Trust. The subordinated units are entitled to receive pro rata distributions from the Royalty Trusts each quarter if and to the extent there is sufficient cash to provide a cash distribution on the common units that is no less than the applicable quarterly subordination threshold. If there is not sufficient cash to fund such a distribution on all common units, the distribution to be made with respect to the subordinated units will be reduced or eliminated for such quarter in order to make a distribution, to the extent possible, of up to the subordination threshold amount on all common units, including common units held by the Company. In exchange for agreeing to subordinate a portion of its Royalty Trust units, SandRidge is entitled to receive incentive distributions equal to 50% of the amount by which the cash available for distribution on all of the Royalty Trust units exceeds the applicable quarterly incentive threshold.

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SANDRIDGE ENERGY, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED
(Unaudited)

The Royalty Trusts declared and paid quarterly distributions during the three-month periods ended March 31, 2014 and 2013 as follows (in thousands):

	Three Months Ended March 31,	
	2014(1)	2013
Total distributions	$68,313	$76,361
Distributions to third-party unitholders	$53,118	$51,256

(1) Subordination thresholds were not met for the Mississippian Trust I’s and Mississippian Trust II’s distributions, resulting in reduced distributions to the Company on its subordinated units for this period.

See Note 18 for discussion of the Royalty Trusts’ distributions announced in April 2014.

Pursuant to the trust agreements governing the Royalty Trusts, SandRidge has a loan commitment to each Royalty Trust, whereby SandRidge will loan funds to the Royalty Trust on an unsecured basis, with terms substantially the same as would be obtained in an arm’s length transaction between SandRidge and an unaffiliated party, if at any time the Royalty Trust’s cash is not sufficient to pay ordinary course administrative expenses as they become due. Any funds loaned may not be used to satisfy indebtedness of the Royalty Trust or to make distributions. There were no amounts outstanding under the loan commitments at March 31, 2014 or December 31, 2013.

The Company and one of its wholly owned subsidiaries entered into a development agreement with each Royalty Trust that obligates the Company to drill, or cause to be drilled, a specified number of wells within respective areas of mutual interest, which are also subject to the royalty interests granted to the Mississippian Trust I, the Permian Trust and the Mississippian Trust II, by December 31, 2015, March 31, 2016 and December 31, 2016, respectively. At the end of the fourth full calendar quarter following satisfaction of the Company’s drilling obligation (the “subordination period”), the subordinated units of each Royalty Trust will automatically convert into common units on a one-for-one basis and the Company’s right to receive incentive distributions will terminate. One of the Company’s wholly owned subsidiaries also granted to each Royalty Trust a lien on the Company’s interests in the properties where the development wells will be drilled in order to secure the estimated amount of drilling costs for the Royalty Trust’s interests in the wells. As the Company fulfills its drilling obligation to each Royalty Trust, development wells that have been drilled and perforated for completion are released from the lien and the total amount that may be recovered by each Royalty Trust is proportionately reduced. In the second quarter of 2013, the Company fulfilled its drilling obligation to the Mississippian Trust I. As of March 31, 2014, the total maximum amount recoverable by the Permian Trust and the Mississippian Trust II under the remaining liens was approximately $85.0 million.

Additionally, the Company and each Royalty Trust entered into an administrative services agreement, pursuant to which the Company provides certain administrative services to the Royalty Trust, including hedge management services to the Permian Trust and the Mississippian Trust II. The Company also entered into derivatives agreements with each Royalty Trust, pursuant to which the Company provides to the Royalty Trust the economic effects of certain of the Company’s derivative contracts. Substantially concurrent with the execution of the derivatives agreements with the Permian Trust and the Mississippian Trust II, the Company novated certain of the derivative contracts underlying the respective derivatives agreements to the Permian Trust and the Mississippian Trust II. The Company novated certain additional derivative contracts underlying the derivatives agreements to the Permian Trust in April 2012 and to the Permian Trust and the Mississippian Trust II in March 2013. The tables below present the open oil and natural gas commodity derivative contracts at March 31, 2014 underlying the derivatives agreements. The combined volume in the tables below reflects the total volume of the Royalty Trusts’ open oil and natural gas commodity derivative contracts.

Oil Price Swaps Underlying the Royalty Trust Derivatives Agreements

	Notional (MBbls)	Weighted Average Fixed Price
April 2014 - December 2014	1,426	$100.70
January 2015 - December 2015	630	$101.03

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Natural Gas Collars Underlying the Royalty Trust Derivatives Agreements

	Notional (MMcf)	Collar Range
April 2014 - December 2014	706	$4.00 — $7.78
January 2015 - December 2015	1,010	$4.00 — $8.55

Oil Price Swaps Underlying the Derivatives Agreements and Novated to the Royalty Trusts

	Notional (MBbls)	Weighted Average Fixed Price
April 2014 - December 2014	722	$100.78
January 2015 - March 2015	141	$100.90

See Note 8 for further discussion of the derivatives agreement between the Company and each Royalty Trust.

The Royalty Trusts are considered VIEs due to the lack of voting or similar decision-making rights of the Royalty Trusts' equity holders regarding activities that have a significant effect on the economic success of the Royalty Trusts. The Company has determined it is the primary beneficiary of the Royalty Trusts as it has (a) the power to direct the activities that most significantly impact the economic performance of the Royalty Trusts through (i) its participation in the creation and structure of the Royalty Trusts, (ii) the manner in which it fulfills its drilling obligations to the Royalty Trusts and (iii) its operation of a majority of the oil and natural gas properties that are subject to the conveyed royalty interests and marketing of the associated production and (b) the obligation to absorb losses and right to receive residual returns, through its variable interests in the Royalty Trusts, including ownership of common and subordinated units, that could potentially be significant to the Royalty Trusts. As a result, the Company began consolidating the activities of the Royalty Trusts into its results of operations upon conveyance of the royalty interests to each Royalty Trust. The common units of the Royalty Trusts owned by third parties are reflected as noncontrolling interest in the consolidated financial statements.

As noted above, the Company fulfilled its drilling obligation to the Mississippian Trust I in the second quarter of 2013. Accordingly, the Mississippian Trust I's subordinated units, all of which are held by SandRidge, will convert to common units at the end of the subordination period. After this conversion, the Company will continue to consolidate the activities of the Mississippian Trust I as its primary beneficiary due to the Company's continued (a) power to direct the activities that most significantly impact the economic performance of the Royalty Trust and (b) obligation to absorb losses and right to receive residual returns through its variable interests in the Royalty Trust, including ownership of common units, that could potentially be significant to the Mississippian Trust I.

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Each Royalty Trust's assets can be used to settle only that Royalty Trust's obligations and not other obligations of the Company or another Royalty Trust. The Royalty Trusts' creditors have no contractual recourse to the general credit of the Company. Although the Royalty Trusts are included in the Company's consolidated financial statements, the Company's legal interest in the Royalty Trusts' assets is limited to its ownership of the Royalty Trusts' units. At both March 31, 2014 and December 31, 2013, $1.3 billion of noncontrolling interest in the accompanying unaudited condensed consolidated balance sheets were attributable to the Royalty Trusts. The Royalty Trusts' assets and liabilities, after considering the effects of intercompany eliminations, included in the accompanying unaudited condensed consolidated balance sheets at March 31, 2014 and December 31, 2013 consisted of the following (in thousands):

	March 31, 2014	December 31, 2013
Cash and cash equivalents(1)	$7,241	$7,912
Accounts receivable, net	22,453	22,540
Derivative contracts	3,300	4,983
Total current assets	32,994	35,435
Investment in royalty interests(2)	1,325,942	1,325,942
Less: accumulated depletion and impairment(3)	(243,971)	(186,095)
	1,081,971	1,139,847
Derivative contracts	—	1,476
Total assets	$1,114,965	$1,176,758
Accounts payable and accrued expenses	$2,157	$3,393
Total liabilities	$2,157	$3,393

(1) Includes $3.0 million held by the trustee at March 31, 2014 and December 31, 2013 as reserves for future general and administrative expenses.
(2) Investment in royalty interests is included in oil and natural gas properties in the accompanying unaudited condensed consolidated balance sheets.
(3) Accumulated depletion and impairment at March 31, 2014 includes full cost ceiling limitation impairment allocated to the Royalty Trusts of $42.3 million. There was no full cost ceiling limitation impairment allocated to the Royalty Trusts as of December 31, 2013.

During the three-month period ended March 31, 2014, the Company sold Permian Trust common units it owned in a transaction exempt from registration pursuant to Rule 144 under the Securities Act, which further reduced its beneficial interest in the Permian Trust. Total proceeds from the transaction were $22.1 million for the three-month period ended March 31, 2014. The sale was accounted for as an equity transaction with no gain or loss recognized. The Company continues to be the primary beneficiary of the Permian Trust, after consideration of this transaction, as well as the primary beneficiary of the Mississippian Trust I and Mississippian Trust II and accordingly, continues to consolidate the activities of the Royalty Trusts. The Company's beneficial interests in the Royalty Trusts at March 31, 2014 and December 31, 2013 were as follows:

	March 31, 2014	December 31, 2013
Mississippian Trust I	26.9%	26.9%
Permian Trust	25.0%	28.5%
Mississippian Trust II	37.6%	37.6%

See Note 10 for discussion of the Company's legal proceedings to which the Mississippian Trust I and Mississippian Trust II are also parties.

Grey Ranch Plant, L.P. Primarily engaged in treating and transportation of natural gas, Grey Ranch Plant, L.P. ("GRLP") is a limited partnership that operated the Company's Grey Ranch plant (the "Plant") located in Pecos County, Texas. As of December 31, 2013, the Company owned a 50% interest in GRLP, which represented a variable interest. Income or loss of GRLP was allocated to the partners based on ownership percentage and any operating or cash shortfalls required contributions from the partners. The Company determined that GRLP qualified as a VIE because certain equity holders lacked the ability to participate in decisions impacting GRLP. Agreements related to the ownership and operation of GRLP provided for GRLP to pay management fees to the

Company to operate the Plant and lease payments for the Plant. Under the operating agreements, lease payments were reduced if throughput volumes were below those expected. The Company determined that it was the primary beneficiary of GRLP as it had both (i) the power, as operator of the Plant, to direct the activities of GRLP that most significantly impact its economic performance and (ii) the obligation to absorb losses, as a result of the operating and gathering agreements, that could potentially be significant to GRLP and, therefore, consolidated the activity of GRLP in its consolidated financial statements. The 50% ownership interest not held by the Company as of December 31, 2013 is presented as noncontrolling interest in the accompanying unaudited condensed consolidated financial statements. In March 2014, one of the Company's wholly owned subsidiaries acquired from a third party the remaining 50% ownership interest of GRLP. Because the Company was the primary beneficiary and consolidated GRLP, the acquisition of additional ownership interest was recorded as an equity transaction with no gain or loss recognized. Additionally, as a wholly owned subsidiary of the Company, GRLP is no longer considered a VIE for reporting purposes.

Prior to the Company's acquisition of the remaining ownership of GRLP in March 2014, GRLP's assets could only be used to settle its own obligations and not other obligations of the Company and GRLP's creditors had no recourse to the general credit of the Company. At December 31, 2013, $0.7 million of noncontrolling interest in the accompanying unaudited condensed consolidated balance sheet was related to GRLP. GRLP's assets and liabilities, after considering the effects of intercompany eliminations, included in the accompanying unaudited condensed consolidated balance sheet at December 31, 2013 consisted of the following (in thousands):

	December 31, 2013
Cash and cash equivalents	$132
Accounts receivable, net	16
Prepaid expenses	32
Other current assets	109
Total current assets	289
Other property, plant and equipment, net	1,163
Total assets	$1,452
Accounts payable and accrued expenses	$129
Total liabilities	$129

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Grey Ranch Plant Genpar, LLC. As of December 31, 2013, the Company owned a 50% interest in Grey Ranch Plant Genpar, LLC ("Genpar"), the managing partner and 1% owner of GRLP. The Company served as Genpar's administrative manager. Genpar's ownership interest in GRLP was its only asset. As managing partner of GRLP, Genpar had the sole right to manage, control and conduct the business of GRLP. However, Genpar was restricted from making certain major decisions, including the decision to remove the Company as operator of the Plant. The rights afforded the Company under the Plant operating agreement and the restrictions on Genpar limited Genpar's ability to make decisions on behalf of GRLP. Therefore, Genpar was considered a VIE. Although both the Company and Genpar's other equity owner shared equally in Genpar's economic losses and benefits and also had agreements that may be considered variable interests, the Company determined it was the primary beneficiary of Genpar due to (i) its ability, as administrative manager and operator of the Plant, to direct the activities of Genpar that most significantly impact its economic performance and (ii) its obligation or right, as operator of the Plant, to absorb the losses of or receive benefits from Genpar that could potentially be significant to Genpar. As the primary beneficiary, the Company consolidated Genpar's activity. However, its sole asset, the investment in GRLP, was eliminated in consolidation. Genpar had no liabilities. In March 2014, one of the Company's wholly owned subsidiaries acquired from a third party the remaining 50% ownership interest of Genpar. Because the Company was the primary beneficiary and consolidated Genpar, the acquisition of additional ownership interest was recorded as an equity transaction with no gain or loss recognized. Additionally, as a wholly owned subsidiary of the Company, Genpar is no longer considered a VIE for reporting purposes.

Piñon Gathering Company, LLC. The Company has a gas gathering and operations and maintenance agreement with Piñon Gathering Company, LLC ("PGC") through June 30, 2029. Under the gas gathering agreement, the Company is required to compensate PGC for any throughput shortfalls below a required minimum volume. By guaranteeing a minimum throughput, the Company absorbs the risk that lower than projected volumes will be gathered by the gathering system. Therefore, PGC is a VIE. Other than as required under the gas gathering and operations and maintenance agreements, the Company has not provided any support to PGC. While the Company operates the assets of PGC as directed under the operations and management agreement, the member and managers of PGC have the authority to directly control PGC and make substantive decisions regarding PGC's activities including terminating the Company as operator without cause. As the Company does not have the ability to control the activities of PGC that most significantly impact PGC's economic performance, the Company is not the primary beneficiary of PGC and does not consolidate the results of PGC's activities into the its financial statements.

Amounts due from and due to PGC as of March 31, 2014 and December 31, 2013 included in the accompanying unaudited condensed consolidated balance sheets are as follows (in thousands):

	March 31, 2014	December 31, 2013
Accounts receivable due from PGC	$1,050	$741
Accounts payable due to PGC	$3,827	$3,634

4. Fair Value Measurements

The Company measures and reports certain assets and liabilities on a fair value basis and has classified and disclosed its fair value measurements using the following levels of the fair value hierarchy:

Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2	Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability.
Level 3	Measurement based on prices or valuation models that require inputs that are both significant to the fair value measurement and less observable for objective sources (i.e., supported by little or no market activity).

Assets and liabilities that are measured at fair value are classified based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement requires judgment, which may affect the valuation of the fair value of assets and liabilities and their placement within the fair value hierarchy levels. The determination of the fair values, stated below, considers the market for the Company's financial assets and liabilities, the associated credit risk and other factors. The Company considers active markets as those in which transactions for the assets or liabilities occur in sufficient frequency and volume to provide pricing information on an ongoing basis. The

Company has assets and liabilities classified as Level 1, Level 2 and Level 3 as of March 31, 2014 or December 31, 2013, as described below.

Level 1 Fair Value Measurements

Restricted deposits. The fair value of restricted deposits invested in mutual funds or municipal bonds is based on quoted market prices. For restricted deposits held in savings accounts, carrying value approximates fair value. Restricted deposits are included in other assets in the accompanying unaudited condensed consolidated balance sheet at December 31, 2013. There were no restricted deposits outstanding at March 31, 2014.

Investments. The fair value of investments, consisting of assets attributable to the Company’s non-qualified deferred compensation plan, is based on quoted market prices. Investments are included in other assets in the accompanying unaudited condensed consolidated balance sheets.

Level 2 Fair Value Measurements

Derivative contracts. The fair values of the Company’s oil and natural gas fixed price swaps and collars are based upon inputs that are either readily available in the public market, such as oil and natural gas futures prices, volatility factors and discount rates, or can be corroborated from active markets. Fair value is determined through the use of a discounted cash flow model or option pricing model using the applicable inputs, discussed above. The Company applies a weighted average credit default risk rating factor for its counterparties or gives effect to its credit default risk rating, as applicable, in determining the fair value of these derivative contracts. Credit default risk ratings are based on current published credit default swap rates.

Level 3 Fair Value Measurements

Guarantees. As discussed in Note 2, the Company has guaranteed on Fieldwood’s behalf certain plugging and abandonment obligations associated with the Gulf Properties. The fair value of these guarantees is based on the present value of estimated future payments for plugging and abandonment obligations associated with the Gulf Properties, adjusted for the cumulative probability of Fieldwood’s default prior to expiration of the guarantee by February 25, 2015 (3.71% at March 31, 2014). The discount and probability of default rates are based upon inputs that are readily available in the public market, such as historical option adjusted spreads of the Company’s senior notes, which are publicly traded, and historical default rates of publicly traded companies with credit ratings similar to Fieldwood’s. The significant unobservable input used in the fair value measurement of the guarantees is the estimate of future payments for plugging and abandonment, which was developed based upon third-party quotes and current actual costs. Significant increases (decreases) in the estimate of these payments could result in a significantly higher (lower) fair value measurement. The significant unobservable input used in the fair value measurement of the Company’s financial guarantee liability at March 31, 2014 is included in the table below (in thousands).

Unobservable Input	
Estimated future payments for plugging and abandonment	$426,661

Derivative contracts. The fair value of the Company’s oil basis swaps outstanding during the three-month period ended March 31, 2013 was based upon quotes obtained from counterparties to the derivative contracts. These values were reviewed internally for reasonableness through the use of a discounted cash flow model using non-exchange traded regional pricing information. Additionally, the Company applied a weighted average credit default risk rating factor for its counterparties or gave effect to its credit risk, as applicable, in determining the fair value of these derivative contracts. The significant unobservable input used in the fair value measurement of the Company’s oil basis swaps is the estimate of future oil basis differentials. Significant increases (decreases) in oil basis differentials could result in a significantly higher (lower) fair value measurement. All of the oil basis swaps outstanding during the three-month period ended March 31, 2013 contractually matured during 2013.

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The following tables summarize the Company’s assets and liabilities measured at fair value on a recurring basis by the fair value hierarchy (in thousands):

March 31, 2014

	Fair Value Measurements			Netting(1)	Assets/Liabilities at Fair Value
	Level 1	Level 2	Level 3		
Assets					
Commodity derivative contracts	$—	$30,803	$—	$(3,753)	$ 27,050
Investments	12,030	—	—	—	12,030
	$12,030	$30,803	$—	$(3,753)	$ 39,080
Liabilities					